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**LEVERAGING ADVERSITY FOR
STRATEGIC ADVANTAGE**

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Companies have been hard hit by a number of economic shocks in recent years. This article discusses steps to take now to minimize the impacts of future episodes of adversity and preserve competitive advantage.

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EXECUTIVE SUMMARY

In 2000-01 companies were hit hard by a number of economic shocks, including industry-specific cycles, the stock market collapse, and national recession. To better understand how companies successfully cope with such adversity, we studied the responses to these recent shocks as well as earlier episodes from the 1980s and 1990s. The study included two surveys of 55 large companies, and in-depth case studies in a subset of those industries.

The results revealed the importance of acting quickly to contain costs as soon as sales growth slows. More importantly, a number of additional actions taken by some companies years before enabled them to successfully deal with the adversity of 2000-01:

- Making sure that executives in key leadership roles had experienced a cyclical industry downturn. This enabled them to tell the difference between short-run sales movements and the early signs of large drop-offs, as well as to implement effective responses.
- Keeping an equal focus on revenue growth, cost containment, and margins. This enabled a constant emphasis on profitability, the ultimate measure of success.
- Making performance management and accountability a mantra, which reinforced the focus on profitability and appropriate resource allocation.
- Honing the company's focus on its customers. This also reinforced the need to determine which existing products and new markets provided the best profit opportunities.
- Avoiding the temptation to load up with debt. This gave top management the breathing room to decipher whether short-run sales movements were just temporary blips. It also provided the resources needed to build capabilities to take advantage of emerging market opportunities, even while losing money on existing product and service offerings.

LEVERAGING ADVERSITY FOR STRATEGIC ADVANTAGE

When economic storm clouds start to gather, the early warning signs are easy to spot. In a world of instantaneously available data, it takes no time for a company's senior leadership to realize when its sales start to slow or fall. The challenge is in knowing how to respond. Do slumping sales represent a momentary blip or the onset of a protracted industry downturn? Will the company be hit harder than its competitors? Is there a national or global recession contributing to the slowdown? Conventional wisdom suggests the following:

- If the company is the only one experiencing problems, both significant cost reductions and a fundamental shift in strategy are commonly prescribed.
- If the source is industry overcapacity, significant cost cutting is often called for; demands to change strategy depend on the company's position relative to the rest of its industry.
- If the cause is a national or global recession with only a relatively mild negative impact on the company, typically only minimal cost cutting is called for, and there is little pressure to alter strategy. If the economy-wide recession is deep or is accompanied by industry overcapacity, then both costs and strategy may need significant attention.

Thus the optimal response appears to be context specific. This creates a problem for top managers. Should they act quickly without sufficient data? Should they wait until they know for sure the cause of the problem? Acting either too soon or too late runs the risk of losing ground to rivals that may never be made up.

In order to shed some light on how executives deal with this problem, the Center for Effective Organizations and Booz-Allen & Hamilton embarked on a research study at the beginning of the 2001 recession to monitor companies' reactions to adversity. The first part of the study consisted of two rounds of surveys of 55 large companies in the spring and in the fall

of 2001. The second part consisted of in-depth interviews at a subset of those companies in four specific industries during fall 2001. The industries chosen for the in-depth analysis were selected because they were experiencing adversity to varying degrees and for different reasons:

- The cellular phone and computer networking industries were deep in the middle of industry cycles that required large-scale capacity shedding.
- The business services industry (consulting; temporary staffing) was reducing capacity, but for a very different reason: an overall slowdown in demand caused by the national recession.
- The consumer products industry was shrinking in some areas, expanding in others, as people shifted from luxury goods to necessities, and from traditional to discount retailers.

Our analysis focused on the coping strategies of industry leaders and other top players. We supplemented the data with case studies from other industries of companies that had undergone significant episodes of adversity in the 1980s and 1990s.

There were two objectives in structuring the study this way. First, we wanted to see in real time how companies coped with the recessionary environment of 2000-01 that seemed to catch many executives by surprise. We wanted to identify what actions, if any, taken prior to the national slowdown put companies in good positions to weather the economic storm. Second, we were concerned that short-run responses to adversity might not be the same as actions needed to thrive in the long run. The historical case studies we examined allowed us to see what company actions taken both before and during episodes of significant adversity led to longer-run competitive advantage.

One set of criteria used to judge success, particularly in the short run, was a company's ability to avoid layoffs and profit losses, or at least to have smaller layoffs and profit losses than its competitors. These criteria were used primarily to evaluate companies experiencing adversity

in 2000-01. The second set of success criteria – more relevant for the longer run – consisted of a company's ability to maintain or increase its market share while remaining profitable in existing product markets, or to profitably enter new product markets. These criteria were used primarily to evaluate the historical cases.

As expected, we found that companies employed a diverse array of strategies for coping with adversity. Nonetheless, we discovered that a fairly consistent set of actions underlay the behavior of companies that were more successful at avoiding and/or coping with the worst bouts of adversity. The first action was taken by successful companies at the onset of adversity:

- Containing costs as soon as sales slowed.

The key differentiator was the speed with which costs were contained. Successful companies did so very quickly at the first signs of trouble. Less successful companies were much slower to respond. Beyond cost containment, the more interesting actions were those taken by successful companies years before to prepare for future episodes of adversity. These actions put such companies in a good position to weather the 2000-01 economic storm:

- Making sure that people who had experienced a cyclical industry downturn held key leadership positions.
- Keeping an equal focus on revenue growth, cost containment, and margins.
- Making performance management and accountability a mantra.
- Honing the company's focus on its customers.
- Avoiding the temptation to load up with debt.

These latter actions were fairly consistently applied at the companies we were studying that were successfully dealing with the 2000-01 period of adversity. But what was particularly informative is that they were also consistently applied at the companies that had successfully dealt with

significant episodes of adversity before that period. Most important, they are actions that any company can take in anticipation of future adversity, regardless of the source. We discuss each of these in detail.

COST CONTAINMENT

During the boom years of the mid- to late 1990s, cost containment seemed further from the mind of business executives than it had for almost a generation. It quickly became a top priority, however, when economic conditions worsened in 2000 in the wake of technology industry and stock market slumps. Our research suggests that this neglected capability was used to maximum competitive advantage when it was employed at the earliest sign of slowing sales.

“Customers First Inc.,” a business services company (not their real name), saw the early signs of a recession before it hit. Through the end of the 1990s, its industry had enjoyed substantial growth. Then, just when it seemed like good times would never end, U.S. sales growth began to slow in the first half of 2000. The head of the company’s U.S. operations was faced with a tough decision in late summer of 2000: with budget season looming in the fall, he had to decide how to act. Revenue was not yet falling, just growing more slowly. If the current pace continued, it would be easy to adjust by slowing down each division’s cost growth rate. Given the pressure to provide high-quality service in the face of stiff competition, he worried that any proactive budget cutting might cede lucrative opportunities to his competitors.

However, his experience told him that it was better to err on the side of caution. So he challenged his vice presidents to immediately reign in cost growth and produce austere 2001 budgets. He faced stiff resistance, but prevailed in the end (and, in hindsight, just in time). Only two months after the budgets were finalized, the company’s year-on-year sales dropped dramatically. In January they were flat to slightly negative; by March they were running in the

negative double digits in percentage terms. The company kept a tight lid on costs throughout 2001. It was able to reduce its headcount by almost 25 percent through hiring freezes and natural attrition. In the meantime, its competitors were forced into much more difficult adjustments (and layoffs) because they did not react as quickly to contain costs.

The importance of early cost containment is evident from other companies we studied. At “We Build ‘Em Inc.,” a technology company (also not their real name), executives took pride in the company’s early years of operating on a shoestring, with extremely high sales-to-staff ratios. The company experienced extremely rapid growth in the 1990s and, in the process, lost sight of how to operate leanly. A new generation of managers focused exclusively on sales growth, even if that meant adding staff without additional revenue to cover the headcount. When industry sales peaked in 2000, the company’s sales-to-staff ratio was much smaller than it had been just five years earlier. Despite the sales drop-off, middle managers continued to hire in expectation of sales picking up again. This proved to be an extremely costly error, as industry sales declined precipitously soon after. In retrospect, it was clear to the company’s executives that – had they stopped hiring much earlier – they could have avoided many of the painful subsequent layoffs.

What is instructive about these examples is that, in both cases, top management did not know ahead of time the full extent of the looming downturn in sales: was it going to be a slow-growth period, a mild national recession? Or, were their industries in for a prolonged period of slumping sales? In retrospect the best action was the same in both cases: as soon as sales growth slowed in 2000, cost containment should have started immediately. Customers First took its medicine early and emerged much stronger than its competitors as a result. We Build ‘Em did not, and ended up going through a sharp round of layoffs that proved extremely demoralizing. This shows the benefits of acting early to contain costs.

But what if the sales drop-off turned out to be more of a temporary blip? Overreacting to short-term sales movements is a real concern. This is why key senior executives should have the experience to recognize the early signs of a steep decline (see the discussion below). Even then, it is not always possible to decipher unclear signals from sales data. Yet in both of these cases early cost containment was the right move even if the eventual sales shortfall had been shallow and temporary. Customers First's headcount reductions took place gradually during 2001 through natural attrition and not filling open positions. Despite the lower headcount, they were able to serve existing customers and pursue new business. Had sales growth resumed mid-year, the hiring freeze could easily have been lifted. As a business services company, customers derive value from working with its employees. Thus it is relatively easy for Customers First to maintain a close link between revenue and the headcount needed to deliver customer value.

The same argument is only a little harder to make in the case of We Build 'Em. As a technology company with substantial investments in inventory and machinery, it faces a tougher time making short-term changes in production than does Customers First. Indeed, this argument was used to justify continued headcount growth even as sales slowed. But consider the CEO's post-crisis objective: getting the sales-to-staff ratio back to its early 1990s levels. In retrospect, he could have used the slowing sales growth in 2000 as the impetus to start bringing the sales-to-staff ratio back in line with those levels. In this case, immediate cost containment was the right move even if the sales slowdown had turned out to be a temporary blip.

Note that avoiding unnecessary layoffs was a priority at both companies. Layoffs are the fastest way to achieve the objective of reduced headcount. But these cases show a less-painful alternative: acting as soon as sales decline to contain costs and insisting on revenue justification

for every new hire. This allows structural churn to do the job of reducing headcount naturally. If necessary, targeted voluntary buyouts can be used as well. Not surprisingly, our study showed that the earlier such processes were put in the place, the easier it was to avoid mass layoffs, though the practices may not preclude the need for later layoffs in all circumstances.

INDUSTRY EXPERIENCE

During the heyday of the 1990s, talented young people commanded a premium in the labor market. The Internet promised to remake the landscape of industries large and small in ways reminiscent of the changes wrought during the Industrial Revolution. Economic growth and productivity were advancing faster than they had for almost a generation. For one brief shining moment, it seemed as if the economy itself might have entered a new era of growth and prosperity. Young managers who spoke the language of this new competitive landscape were promoted quickly. Our study found, however, that many of these promotions subsequently hampered companies' ability to deal with the recession and industry down-cycles.

Having the ability to differentiate week-to-week sales blips from the early warning signs of a protracted downturn is a key leadership trait. Equally important is the knowledge of how to successfully adjust the company's operations in response to revenue gaps, cutting back expenses where possible while preserving budgets in mission-critical areas. Both of these capabilities were de-emphasized or missing entirely among the young executives promoted in recent years.

The companies in our study that most successfully dealt with recent bouts of adversity following years of easy growth more often than not had heavy representation of industry long-timers among their leadership team. The views of these "elderly statesmen" (and women) were not held in high regard to the exclusion of ideas and insights from the emerging generation of youthful leaders. But they similarly were not subordinated to the views of executives who had

never seen hard times in their industries. The way companies that successfully dealt with adversity handled this tradeoff was by explicitly looking to the younger generation for ideas on how to make money, while preserving key roles for the older generation to play in operationalizing those ideas. In doing so, they maintained an institutional memory among the leadership team of what times were like in previous episodes of adversity. Customers First, discussed above, is a prime example of this; see also Andy Grove's quote below about the long-lasting impact on Intel's leadership of their mid-1980s crisis.

MARGINS AND PROFIT

The phenomenal performance of telecommunications' and technology upstarts' stocks during the 1990s was the envy of executives everywhere. This led managers in other industries to consider focusing on growth first, profits second, even if that meant recasting key parts of their business as technology or internet plays. The danger of this was revealed when the stock market fell abruptly in 2000, and the telecommunications and technology companies' stocks fell disproportionately relative to other industries. It seemed that, almost overnight, profitability again became the key metric.

From the CEO's perspective, enhancing profit is a "simple" matter: you do it by growing revenue faster than costs. The problem is that, once they leave the CEO's desk, ownership over both of these tasks almost immediately is bifurcated across two different parts of the organization: sales and operations. How you get those two parts to work in unison is a time-honored organization design question. What is telling is the extent to which companies do not effectively address this issue.

When a company goes from healthy balance sheets to being virtually insolvent, it is easy to see in retrospect how key sales and operations missteps led to the downfall. What is harder to

see, though no less important, is that many successful companies have faced similar crises at some point in their history. Our research suggests that it is the ability to focus and effectively coordinate around profitability in the face of a challenge that separates successful from unsuccessful companies. Consider the examples of Intel and G.E.

In the early 1980s, Intel was quickly losing market share to its Japanese competitors in the memory chip business. What had been a high-margin, cash cow business for the company was quickly becoming unprofitable. In one of the most celebrated decisions in recent corporate history, the company decided to abandon the memory chip business, a business that it had helped pioneer and which formed the core of its identity. Intel's subsequent switch to microprocessors in the mid- to late 1980s drove phenomenal growth that made the company into the giant that it is today. While this is an old story, that does not diminish its relevance as a historical case study for the purposes of our discussion here. Indeed, a number of the people we interviewed both inside and outside the company cited this period in Intel's history as a model for coping with adversity for companies in general.

The key insight is that, prior to making the switch, Intel already had in place decision making processes and rewards for lower level managers that pushed them to allocate resources to the products that were the most profitable for the company. This in turn put the company in a prime position to leverage subsequent adversity to its strategic advantage. As Grove relates in his 1996 book *Only the Paranoid Survive*:

“while Intel's business changed and management was looking for clever memory strategies and arguing among themselves, trying to figure out how to fight an unwinnable war, men and women lower in the organization, unbeknownst to us, got us ready to execute the strategic turn that saved our necks and gave us a great future ... Bit by bit, they allocated more and more of our silicon wafer production capacities to those lines which were more profitable, like microprocessors, by taking production capacity away from the money-losing memory business ... By the time we made the decision to exit the memory business, only one out of eight

silicon fabrication plants was producing memories. The exit decision had less drastic consequences as a result of the actions of our middle managers.”

While Grove rightfully gives credit where it is due, he and the rest of the leadership team had long before prepared the organization for change by putting in place the right reward systems and managerial processes to focus lower level managers’ attention on profitability.

Not all sectors of the economy experienced rampant growth in the heyday of the 1990s. Companies in the consumer products sector in particular faced a tough time making money, as they always seem to do. As Jeff Immelt, CEO of General Electric, recently commented to *Business Week*,

“the way we use a business like appliances is, it’s a great place to train people. It’s a great way for managers to go there and learn what a recession is like. Because those businesses are in recession almost all the time. Even the good years are tough. So you learn unbelievable management skills at businesses like that.”

Consumer products companies, retailing and the temporary staffing industry provide numerous examples of organizations that struggle to make money on a daily basis. The difference between being an industry leader versus laggard – in terms of both market share and profitability – can be determined by differences in operating margins as small as one or two percentage points. Our study found that the strategy capable of producing above average performance in these industries on a consistent basis relied on fairly common management principles designed to keep the organization focused on margins and profitability:

- Be eternally vigilant to ensure no major lapses in product and service quality.
- Keep a laser-like focus on operational processes to efficiently squeeze out every last penny.
- Innovate for competitive advantage.

Note that innovation in these industries typically has a much more limited, short-term impact than it does in knowledge-intensive industries such as computer software and financial services which operate with greater economies of scale and margins. In these industries the difficulty in

creating “category killer” products makes it more important to focus on sales and operations as sources of competitive advantage and coping with adversity.

PERFORMANCE MANAGEMENT AND ACCOUNTABILITY

When the stock market was booming and the economy was growing rapidly in the late 1990s, companies with both good and bad performance management found it easy to raise money and stay in business. The 2000 stock market slide and nascent economic slowdown then turned the tide against those with bad business plans. Suddenly performance management and accountability were back in vogue. Yet the companies that have fared best under recent adverse conditions were ones that had good performance management processes, reward systems, and cultures of accountability in place long before the 2000-01 recession. All along they had viewed these as part and parcel of what provided them with a competitive edge.

What is even more telling is the history of those systems and cultures of accountability. In companies we studied that had exemplary systems and practices, we were able to trace their origins back to an early time of adversity. In these cases, the inability to avert a previous crisis was due either directly or indirectly to a sub-par performance management culture. As part of painful downsizing and restructuring efforts, these companies subsequently established systems to hold people accountable, with real consequences, when performance fell short. In contrast, companies with poor current practices had never been subjected to such adversity or, if they had, did not learn from those episodes. Consider Frito-Lay and Intel.

Frito-Lay lost ground to its competitors in the late 1980s and early 1990s and allowed expense growth to get ahead of sales. With a dominant market share, it became complacent. When Roger Enrico took over in 1991, he initiated a round of fierce cost cutting. He set goals for the company to attain annual revenue growth of at least 6 percent and profit growth of at least 10

percent – this in an industry that historically had grown much more slowly. These stretch goals were maintained throughout the 1990s, even after the turnaround was complete and sales started to boom. The end result was an enormous hike in market share (an increase of about twenty percentage points of total industry sales) and operating margins that were high for a consumer products company, and even higher relative to their competitors in the food business.

Frito-Lay's success has been due in no small part to aligning the company's approach to performance management and accountability with the stretch goals. Weekly meetings cover the latest sales and production figures, including reasons for any deviation from planned growth in every single market. Managers at all levels are included in the process. This maximizes information sharing, which helps achieve the goals. But it also makes for a very transparent process: the performance objectives are clear to everyone, and it is easy to identify sub-par performers. Consequently, it is easy to hold individuals accountable for their performance while minimizing the adverse reactions among co-workers (such as defensiveness, mistrust) that typically arise when performance management objectives are less transparent.

The snack foods industry did not go through the same kind of retrenchment that characterized other industries in the 2000-01 recession. Yet the keys to Frito-Lay's continued success lie in the company's atmosphere of "manufactured adversity" (quoting a senior manager) that is created by the stretch goals. Regardless of how well or poorly their competitors are doing, Frito-Lay is committed to achieving revenue and profit goals that most companies would view as unattainable given the nature of their core business.

A comparable story can be told about Intel. Building off the painful lessons learned during the mid-1980s, Intel formalized systems designed to keep the organization focused on profitability. For example, their redeployment process constantly identifies the highest return

businesses and reallocates investment dollars and headcount away from products that are not profitable. To reinforce performance management and accountability, redeployed employees have to apply for new jobs internally (they maintain full pay and benefits for a number of months while doing so). During the boom times that Intel experienced as its microprocessor business took off, it would have been easy to abandon such systems. Yet, even after a decade of outstanding growth, in Grove's words:

“Most of our managers still remember what it felt like to be on the losing side. Those memories make it easy to conjure up the lingering dread of a decline and generate the passion to stay out of it. It may sound strange but I'm convinced that the fear of repeating 1985 and 1986 has been an important ingredient in our success.”

Our research revealed that the healthy benefits of such fears persisted at Intel through the end of the 1990s as well.

In both of these cases and others that we studied, what made the companies stand out from the crowd was not that they had adopted a performance management system and accountability when the downturn occurred in 2000-01. Rather, it was that they already had one and stuck with it even as the stock market boomed and economic growth took off. This was particularly telling in light of the difficulties created by the late 1990s tight U.S. labor market. Many companies that struggled to hold people accountable during this period decried the difficulties in doing so. They worried about what would happen to their collegial cultures, and how they would be able to attract top-notch talent if alternative jobs did not carry the same pressure to be accountable. This led to some self-doubt even among our best practice companies at the height of the Internet and dot-com booms, as many people shunned working in “traditional” companies for the chance to get rich quick in the IPO frenzy.

After the economic downturn, the companies in our study with good performance management approaches and cultures of accountability were left standing, and many were even

stronger than before relative to their competitors. Not all had been perfect at maintaining strict accountability: some relaxed their standards to facilitate hiring at the height of the tight labor markets. But the companies that relaxed their standards the least found it easiest to weather the storm on two counts. First, they typically had remained most vigilant in focusing on the bottom line. In doing so they had grown less fat and complacent and were able to avoid crippling layoffs better than their competitors. Second, the stricter the culture of performance and accountability, the easier it was for them to identify poor performers and make needed layoffs without suffering the kinds of demoralizing aftershocks that have left deep scars at other companies.

CUSTOMER FOCUS

Platitudes about being “customer-oriented” are almost universal in business these days. What is missing from company mission statements is a recipe for how to have both happy customers and healthy bottom lines. This is no small task because the most direct route to customer satisfaction is through providing higher quality at lower prices, both of which are at odds with making a profit (in the absence of dramatic advances in innovation and productivity). Our study provides a new look at the issue of customer focus. In a number of notable cases – IBM and Nokia for example – the emergence of a winning formula for making high profits while satisfying customers can be traced back to an earlier period of adversity that predated each company’s successful recent years.

IBM’s current position as a market leader in Internet and computer services was anything but a foregone conclusion when Lou Gerstner took over as CEO in 1993 during a period of severe adversity. The company had fallen so far out-of-touch with what its customers wanted, it was unclear it would ever recover. The company did so by remaking itself into a more customer-responsive organization, but not at the expense of profitability. Sam Palmisano, IBM’s recently-

appointed CEO, helped build the services part of the business during the mid- to late 1990s by focusing on profits from day one and not treating services as a loss leader. By the time the technology recession hit in full force in 2000-01, the company had transformed its business model to the point where services accounted for half of pre-tax profits.

This new orientation was critical to weathering the recession. By focusing on long-term customer relationships via service contracts, the company de-emphasized the impact on its profitability of the short-term, transactional nature of many technology purchases. Of course, service was not unfamiliar territory for IBM, which was used to working on long-term contracts for its mainframe computers. However, the period of adversity motivated a shift to put service front and center; it no longer was an add-on to help with hardware sales. Note that the company's focus on longer-term customer relationships was not discovered suddenly when technology industry hardware sales started to fall in 2000. Rather, it was shaped years before during an earlier period of idiosyncratic adversity when it was clear the company had to change to survive.

Nokia's early 1990s period of adversity was as bad, if not worse, than IBM's: the unfocused conglomerate was in businesses as diverse as lumber, TVs, diapers and rubber boots. Although they had a strong presence in telecommunications, that segment was losing money along with many others. Things were so desperate that their largest shareholder tried to sell the company to Ericsson, which declined the offer.

Nokia's key strategic insight, which subsequently transformed their entire business, was the decision to create a cell phone brand. This forced them to focus on delivering value to the end-user that would create loyalty. Their immediate objective was to make money again on cell phones. They succeeded to the point where they became the market leader in 1998, and accounted for two-thirds of all profits in the industry in 1999 (despite having a relatively modest,

though leading, market share of only one quarter of all cell phone sales). The true extent of their success, though, was demonstrated when the industry cycle hit in 2000-01. They weathered the storm with layoffs of only 2 percent of their workforce, and continued to make money while their competitors bled red ink.

Of course, the reasons behind Nokia's and IBM's recent successes reflect more than just being customer focused. In both cases, the company became proficient at producing products and services with a better combination of price and quality than its competitors could deliver. To a certain extent they were in the right place at the right time when growth accelerated in new market categories. But that is the essence of being customer focused: the more in touch a company is with the needs and desires of its customers, the better it can position itself to provide market-leading products and services as new segments develop. The flip side is that a company needs to be vigilant in watching for signs that a particular market segment in which it excels is starting to wane, either because competitors are gaining ground, or because the entire segment is falling out of favor with customers.

LEVERAGE

Adversity is very hard to anticipate. Without advance warning, it is difficult for a company to respond to large fluctuations in demand without making painful adjustments. Having lots of cash on hand allows the option of waiting as long as possible before making deep cuts in personnel and other core expenses. For this reason, our study identified maintaining low debt as another action that enabled companies to successfully cope with adversity.

The ability to delay making painful adjustments such as layoffs is what provides competitive advantage. Companies that are not highly leveraged can draw down their cash reserves for weeks or months while they wait to see whether a sudden drop in revenue is a short-

term fluctuation to be ridden out, or a longer-term fall-off requiring reductions in overhead and operating expenses. The highly leveraged company is more susceptible to pressure from creditors, even in cases of short-term losses that might be due to a mild national recession. Its competitors with larger cash cushions can ride out the initial time of uncertainty without making large adjustments. But the highly-leveraged company can be forced to make cuts right away that in retrospect end up looking premature. Doing so opens the door for competitors to use its weakened state to take business away. It also makes the company vulnerable to losing key talent (and the knowledge they possess) that might leave voluntarily in anticipation of further layoffs.

Note that this is consistent with the principle cited above of moving quickly to contain costs. In fact, these two strategies in essence represent different manifestations of the same principle. In both cases, the objective is to avoid unnecessary layoffs. The initial cost containment is needed to preserve the existing headcount (or allow it to fall through natural attrition) and knowledge base. Selectively drawing down cash reserves to avoid making layoffs prematurely is part and parcel of that strategy. Through careful use of both strategies, a company can buy itself the maximum time possible to determine whether a fall-off in sales is due to a short-run blip or longer-term drop in revenue. Then, if cuts are necessary, the hope is that the company's competitors would already be making cutbacks as well, which should lessen the extent of voluntary quits above and beyond the required layoffs.

Looking long-term, even in cases where deep cuts are required, maintaining low debt levels can provide enormous strategic advantage. When Cisco Systems' market for Internet routers collapsed, the company was forced to lay off a large percentage of its workforce. As painful as those adjustments were, Cisco's competitors fared as poorly or worse. And Cisco had the advantage of having billions of dollars in cash and equivalents on hand, enough to support

many years of operations without another penny in revenue. This cushion has afforded Cisco's leader the luxury of taking the time needed to figure out where the next source of growth will come from, whether in Cisco's traditional markets or via new opportunities that are not yet core to what they do. It also gives them the ability to build capabilities that meet the needs of new market opportunities.

Cisco's case is instructive because the company made significant reductions in its core operating costs despite having such a large cushion of cash. This was the right move because the company (and its competitors) had received unequivocal signals from their customers that a fundamental slowdown in the entire market for Internet backbone equipment had occurred. Without the cuts, Cisco would have continued to lose money until it was forced into bankruptcy: the demand for its products into the foreseeable future simply could not support the previous levels of headcount and operating expenses. Having the cash cushion did, however, give Cisco sufficient time to delay making cuts until the point where it was clear that the drop in demand from the dot-com and telecommunications industry failures was not just a transitory phenomenon, rather a long-lasting hit to its revenue growth prospects. It also let the company make better decisions about what to cut and how to build for the future.

IT IS NEVER TOO LATE TO LEARN

Companies that have not previously heeded the prescriptions discussed here and find themselves worse off than their competitors after a recent episode of adversity need not necessarily despair. Even among the group of underperforming companies in our study, there were signs that adversity could be leveraged for strategic advantage, particularly in terms of preparing for future success. In one case, a technology company that had helped establish multiple product markets with pathbreaking innovations was losing money in a number of its

businesses. The company's flagship consumer products provided the biggest visibility for the company's overall brand. Yet in those businesses it had ceded critical ground to its competitors for years and continued to lose market share.

Despite the difficulties in its consumer products division, the company maintained dominant positions in a number of business-to-business product markets. For years, the leadership for all of its business units had been drawn from the ranks of technologists who understood how to innovate, but not necessarily how to make money doing so. These leaders were lacking in general management skills. Despite this, they had been fortunate enough to guess right in creating products that could make money without an approach that effectively integrated research, development, and marketing.

Having seen its once-dominant market share in consumer products slip away, the company did not wait to have the same thing happen in its business products segments. Instead, it proactively brought in leaders for those units who have the general business skills that are critical for success today. It also is introducing performance management and reward systems designed to hold people accountable for making marketable products. In these ways, the company is trying to leverage a period of extreme adversity in its consumer products unit to the competitive advantage of its business products divisions. If the results of our study offer any guidance, they are on the right track.

Of course, taking actions such as redesigning reward systems, moving from a revenue growth to margin enhancing orientation, and reducing leverage cannot happen on a whim. Doing so means incurring significant up-front costs, costs that may seem difficult to justify for companies that are not currently undergoing bouts of adversity. That said, the benefits of providing protection against the negative consequences of future adversity are real and

important. Perhaps the best option for companies not currently in crisis is to have the senior leadership be as realistic as possible in doing scenario planning across a wide range of future states of the world. They can then use the worst-case scenarios as impetus for deciding on and implementing gradually changes to the organization's structure, systems and processes to prepare for future adversity.

CONCLUSION

The key issues outlined here are all part of a system of levers that works best as an interconnected whole, not standalone initiatives. Keeping a sharp focus on profitability requires knowing what the customer wants and is willing to pay for. It also means maintaining good performance management systems and enforcing accountability. Having the ability to cut costs quickly in response to flagging sales is critical. Knowing where to cut back and where to maintain spending to preserve competitive advantage is a key capability. Nurturing a leadership team capable of determining whether early signals from the market are a short-run blip or a sign of worse things to come is also critical. Moreover, having a low-debt balance sheet helps provide that leadership with breathing room to take the time to decipher market signals. While none of these actions and capabilities alone can inoculate a company against all adversity, together they can provide an effective vaccine to help minimize its impacts, regardless of the source of adversity.

SELECTED BIBLIOGRAPHY

For additional insights on leadership issues that emerged from our study, see the article by Bruce A. Pasternack and James O'Toole, "Yellow-Light Leadership: How the World's Best Companies Manage Uncertainty," in *strategy+business*, Issue 27, Second Quarter 2002.

Both quotes by Andrew Grove on Intel come from his book, *Only the Paranoid Survive* (Bantam Books, 1999). Jeffrey Immelt's quote on G.E. comes from "Q&A: A talk with Jeff Immelt" (*Business Week*, January 28, 2002).

For some background information on the companies and episodes of adversity discussed here:

- "IBM's New Boss: Sam Palmisano has a tough act to follow" (*Business Week*, February 11, 2002).
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- "Nokia Rocks Its Rivals: Flawless execution put Nokia on top. Will customer love keep it growing?" (*Fortune*, March 4, 2002).
- "Frito-Lay Is Munching on the Competition: Under Roger Enrico, both profits and market share are up" (*Business Week*, August 24, 1992).

Of course there is an entirely different type of adversity that has been featured prominently of late: accounting-related scandals such as Enron made famous. Our focus here was

on adversity that is related to having the wrong strategy and/or economic cycles. For a good discussion of Enron-related issues, as well as the more “traditional” types of adversity discussed here, see *The Economist*, “Back to basics: A survey of management,” March 9, 2002.

BIOGRAPHY

Alec R. Levenson is a Research Scientist at the Center for Effective Organizations in the Marshall School of Business at the University of Southern California. Dr. Levenson's research focuses on the economics of human resources and organization design, metrics and return on investment, and strategy. Topics include ROI for teams and HR systems; how companies manage for success in times of adversity; the bottom-line rationale for implementing basic education programs in the workplace; the skills needed for effective general manager performance; factors impacting employee attraction, retention and motivation; and contingent work. His prior research addressed labor market trends and policy-related topics in the U.S., Taiwan and Mexico.

Dr. Levenson's research has been published in the *Economic Journal*, *Journal of Public Economics*, *Journal of Development Economics*, *Contemporary Economic Policy*, *Review of Development Economics*, and *Small Business Economics*. He is the co-editor of *Labor Markets, Employment Policy, and Job Creation* (1994), and a member of the editorial board of *Small Business Economics*. He has received research grants from the Russell Sage Foundation, the Rockefeller Foundation, the National Science Foundation, and the National Institute for Literacy.

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